

MAI SYSTEMS CORP
Form 10-Q
November 06, 2003

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, DC 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the period ended September 30, 2003 or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the transition period from to .

Commission file number: 1-9158

MAI Systems Corporation
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

22-2554549
(IRS Employer Identification No.)

26110 Enterprise Way, Lake Forest, CA 92630
Address of principal executive offices

Registrant's telephone number including area code **(949) 598-6000**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate market value of the common stock held by non-affiliates of the registrant, based upon the last sale price of the Common Stock reported on the National Association of Securities Dealers Automated Quotation National Market System on October 20, 2003 was \$1,487,575.

The number of shares of common stock issued, outstanding and subscribed as of October 20, 2003 was 14,875,752.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

MAI SYSTEMS CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

	(in thousands, except share data)	
	As of December 31, 2002	As of September 30, 2003 (unaudited)
<u>ASSETS</u>		
Current assets:		
Cash	\$ 545	\$ 161
Receivables, less allowance for doubtful accounts of \$336 in 2002 and \$338 in 2003	1,834	1,715
Inventories	60	77
Notes receivable	250	
Prepays and other assets	628	618
Total current assets	3,317	2,571
Furniture, fixtures and equipment, net	843	821
Intangibles, net	1,823	2,601
Other assets	194	44
Total assets	\$ 6,177	\$ 6,037
<u>LIABILITIES AND STOCKHOLDERS' DEFICIENCY</u>		
Current liabilities:		
Current portion of long-term debt	\$ 3,289	\$ 3,506
Accounts payable	1,077	864
Customer deposits	1,811	1,963
Accrued liabilities	2,007	2,466
Income taxes payable	89	87
Unearned revenue	3,693	3,483
Total current liabilities	11,966	12,369

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

Long-term debt	7,234	7,193
Other liabilities	1,759	1,026
Total liabilities	20,959	20,588
Commitments and contingencies		
Stockholders' deficiency:		
Preferred Stock, par value \$0.01 per share; 1,000,000 shares authorized, none issued and outstanding		
Common Stock, par value \$0.01 per share; authorized 24,000,000 shares; 14,675,752 and 14,875,752 shares issued, outstanding and subscribed at December 31, 2002 and September 30, 2003, respectively.		
	150	152
Additional paid-in capital	218,251	218,112
Accumulated other comprehensive loss:		
Minimum pension liability	(918)	(918)
Foreign currency translation	(31)	(2)
Unearned Compensation	(91)	(62)
Accumulated deficit	(232,143)	(231,833)
Total stockholders' deficiency	(14,782)	(14,551)
Total liabilities and stockholders' deficiency	\$ 6,177	\$ 6,037

The accompanying notes are an integral part of these condensed consolidated financial statements.

MAI SYSTEMS CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	(Unaudited) For the Three Months Ended September 30,		(Unaudited) For the Nine Months Ended September 30,	
	(in thousands, except per share data)		(in thousands, except per share data)	
	2002	2003	2002	2003
Revenue:				
Software	\$ 1,396	\$ 842	\$ 3,787	\$ 3,098
Network and computer equipment	328	104	731	339
Services	3,987	3,868	12,413	11,315
Total revenue	5,711	4,814	16,931	14,752
Direct costs:				
Software	158	167	507	425
Network and computer equipment	276	73	569	238
Services	1,366	1,109	4,485	3,384
Total direct costs	1,800	1,349	5,561	4,047
Gross profit	3,911	3,465	11,370	10,705
Selling, general and administrative expenses	2,404	2,307	6,787	7,277
Research and development costs	797	764	2,461	2,104
Amortization of intangibles	25		134	
Other operating (income) loss	232	(134)	237	(181)
Operating income	453	528	1,751	1,505
Interest income	1		4	1
Interest expense	(372)	(286)	(1,146)	(928)
Other non-operating expense	(14)	(98)	(41)	(309)
Income from continuing operations before income taxes	68	144	568	269
Income tax benefit (expense)	(8)	(12)	(16)	41
Income from continuing operations	60	132	552	310
Loss from discontinued operations	(223)		(43)	
Net income (loss)	\$ (163)	\$ 132	\$ 509	\$ 310
Income (loss) per share:				

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

Continuing Operations:

Basic income per share	\$	0.00	\$	0.01	\$	0.04	\$	0.02
Diluted income per share	\$	0.00	\$	0.01	\$	0.04	\$	0.02

Discontinued Operations:

Basic income (loss) per share	\$	(0.01)	\$	0.00	\$	0.00	\$	0.00
Diluted income (loss) per share	\$	(0.01)	\$	0.00	\$	0.00	\$	0.00

Net income per share:

Basic income (loss) per share	\$	(0.01)	\$	0.01	\$	0.04	\$	0.02
Diluted income (loss) per share	\$	(0.01)	\$	0.01	\$	0.04	\$	0.02

Weighted average common shares used in determining income (loss) per share:

Basic	14,119	14,575	13,876	14,525
Diluted	14,569	14,875	14,326	14,825

The accompanying notes are an integral part of these condensed consolidated financial statements.

MAI Systems Corporation

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the Nine Months Ended September 30, (in thousands)	
	2002	2003
Net cash provided by operating activities:	\$ 1,933	\$ 619
Cash flows used in investing activities:		
Proceeds from note receivable		250
Capital expenditures	(128)	(240)
Acquisition of unconsolidated subsidiary		(79)
Capitalized software development costs	(615)	(619)
Net cash used in investing activities	(743)	(688)
Cash flows from financing activities:		
Net decrease in line of credit	(280)	
Repayments on long-term debt	(89)	(312)
Net cash used in financing activities	(369)	(312)
Net cash provided by (used in) continuing operations	821	(381)
Net cash used in discontinued operations	(1,487)	
Effect of exchange rate changes on cash	(13)	(3)
Net change in cash	(679)	(384)
Cash at beginning of period	1,224	545
Cash at end of period	\$ 545	\$ 161

See note 5 for disclosure on non -cash transactions.

The accompanying notes are an integral part of these condensed consolidated financial statements.

MAI Systems Corporation

Notes to Condensed Consolidated Financial Statements

Three Months ended September 30, 2003

(Unaudited)

1. Basis of Presentation

Companies for which this report is filed are MAI Systems Corporation and its wholly owned subsidiaries (the Company). The information contained herein is unaudited, but gives effect to all adjustments (which are normal recurring accruals) necessary, in the opinion of Company management, to present fairly the condensed consolidated financial statements for the interim period. All significant intercompany transactions and accounts have been eliminated in consolidation.

Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC), and these financial statements should be read in conjunction with the financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002, which is on file with the SEC.

2. Liquidity

Although the Company has a net stockholders' deficiency of \$14,551,000 and a working capital deficit of \$9,798,000 (which includes subordinated debt due to CSA of \$2,800,000, see note 7) at September 30, 2003, the Company believes it will continue to generate sufficient funds from operations and obtain additional financing or restructure its subordinated note with CSA to meet its operating and capital requirements. The Company is currently in negotiations with CSA to restructure the terms of the existing debt, including extending the maturity date. The Company expects to generate positive cash flow from its continuing operations during 2003 from shipping out products and services from its current backlog as of September 30, 2003 as well as new orders. In the event that the Company cannot generate positive cash flow from its continuing operations during 2003, the Company can substantially reduce its research and development efforts to mitigate cash outflow to help sustain its operations. There can be no assurance that the Company will be able to sustain profitability, generate positive cash flow from operations or restructure its debt as necessary. These financial statements have been prepared assuming the Company will continue to operate as a going concern. If the Company is unsuccessful in the aforementioned efforts, the Company could be forced to liquidate certain of its assets, reorganize its capital structure and, if necessary, seek other remedies available to the Company, including protection under the bankruptcy laws.

The restructured debt, pursuant to the original inter-creditor agreement between Canyon Capital and Coast, which was sold to Wamco on May 15, 2003, contains various restrictions and covenants. In the event that the Company were not in compliance with the various restrictions

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

and covenants and were unable to receive waivers for non-compliance, the term debt would be immediately due and payable. The Company was not in compliance with but received a waiver for one of its covenants as of and for the three month period ended September 30, 2003 (see note 7). There is no guaranty that the Company will meet its debt covenants in the future. The Company is currently negotiating with Wamco to change such covenants, but there is no assurance that the Company will be able to successfully change the covenants.

3. Inventories

Inventories are summarized as follows:

	(dollars in thousands)	
	December 31, 2002	September 30, 2003
Finished goods	\$ 45	\$ 63
Replacement parts	15	14
	\$ 60	\$ 77

4. Plan of Reorganization

In connection with the Company's Chapter 11 bankruptcy proceedings in 1993, shares of Common Stock are currently being distributed by the Company to its former creditors pursuant to the Plan of Reorganization (the Plan) as approved by United States Bankruptcy Court. The Company does not anticipate that additional shares will be issued under the plan. As of September 30, 2003, 6,758,251 shares had been issued pursuant to the Plan.

Notwithstanding the confirmation and effectiveness of its Plan of Reorganization pursuant to which the Company emerged from a voluntary proceeding under the bankruptcy laws, the United States Bankruptcy Court continues to have jurisdiction, among other things, to resolve disputed pre-petition claims against the Company, to resolve matters related to the assumptions, assignment or rejection of executory contracts pursuant to the Plan, and to resolve other matters that may arise in connection with the implementation of the Plan.

5. Business Acquisitions

Hotel Information Systems, Inc.

Effective August 9, 1996, the Company acquired substantially all of the assets and assumed certain liabilities of Hotel Information Systems, Inc. (HIS) pursuant to an asset purchase agreement dated June 30, 1996 (as amended July 10, 1996) for 1,179,000 unregistered shares of the Company's common stock valued at \$10,900,000. The net assets acquired from HIS are used in the business of software design, engineering and service relating to hotel information systems. The net assets also included subsidiaries of HIS in Singapore, Hong Kong and Mexico. The acquisition of HIS has been accounted for by the purchase method of accounting. The total purchase price for HIS was \$21,373,000, which included net liabilities assumed of HIS of \$7,873,000 and acquisition costs of approximately \$2,600,000.

During 1996, the Company entered into arbitration proceedings regarding the purchase price of HIS. The Company placed approximately 1,100,000 shares of Common Stock issued in connection with the acquisition of HIS in an escrow account to be released in whole, or in part, upon final resolution of post closing adjustments.

In November 1997, the purchase price for the acquisition of HIS was reduced by \$931,000 pursuant to arbitration proceedings. As a result, goodwill was reduced by \$931,000 and approximately 100,650 shares were required to be released from the escrow account and returned to the Company (this has not occurred as of September 30, 2003). In addition, the Company had further claims against HIS relating to legal costs and certain disbursements inappropriately made by HIS prior to the closing estimated at \$650,000. The Company was required, as needed, pursuant to the asset purchase agreement and related documents, to issue additional shares of Common Stock in order that the recipients ultimately receive shares worth a fair value of \$9.25 per share. This adjustment applied to a maximum of 73,466 shares of Common Stock. As of September 30, 2003, the fair market value of the Company's common stock was \$0.09 per share, which would have resulted in approximately 5,755,453 additional shares being issued. Also, included in the escrow account at December 31, 2002 are 200,000 shares of the Company's common stock, which do not have a guarantee of value.

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

On March 25, 2003, the Company entered into a settlement agreement with HIS and one of its former corporate officers whereby (i) the parties dismissed all claims, known and unknown, against each other; (ii) the Company forgave and wrote off a note receivable from the former corporate officer of HIS in the amount of \$66,000 (which was expensed to other expense in the 2002 consolidated statement of operations); (iii) the Company paid \$50,000 in cash and issued a non-interest bearing unsecured promissory note which requires 35 consecutive monthly payments of \$5,000 each commencing April 1, 2003; and (iv) the remaining 374,116 shares in the escrow account will be released to the Company. If the Company is delinquent four times in any twelve month period during the term of the unsecured promissory note in making its \$5,000 monthly payments to HIS, and HIS issues respective valid default notices, the Company will be subject to a \$225,000 penalty. The 374,116 shares have been received by MAI together with the HIS authorization to legally transfer such shares to MAI.

Imputing interest at 11%, the present value of the \$175,000 promissory note at the date of the settlement was \$149,000. The Company recorded the present value of this debt issuance and the \$50,000 cash payment as a reduction to additional paid-in capital.

Hospitality Services & Solutions

On June 23, 2002, the Company acquired substantially all of the assets and assumed certain liabilities of Hospitality Services & Solutions (HSS) including a 35% ownership in AMDB HIS (AMDB) pursuant to a stock purchase agreement for 100,000 shares of common stock valued at \$32,000 (the quoted market price of the common stock at the time the terms were agreed), and \$75,000 in cash. Additionally, the shareholders of HSS received a 20% minority

interest in the Company's combined operations in Asia. HSS was acquired for the Company to expand its operations in the Asian marketplace, strengthen its management team in the territory and create new opportunities for its new enterprise capable suite of products. The net assets acquired from HSS are used in the business of software design, engineering and service relating to hotel information systems. The net assets also include subsidiaries of HSS in Malaysia, Singapore and Thailand. The Company recorded \$297,000 of goodwill (deductible for tax purposes) in connection with the acquisition of HSS. Pro forma results of operations as if this acquisition had occurred at the beginning of 2001 and 2002 are not shown because its impact would have been immaterial.

Included in the acquired assets of HSS was a 35% interest in AMDB, an online reservation service, originally purchased by HSS for \$66,000. On February 20, 2003, the Company entered into an agreement whereby it acquired the remaining 65% for \$79,000 payable over 6 month installments. The net liabilities of \$15,000 acquired are used to support an online reservation service related to hotel information systems. The Company recorded \$160,000 of goodwill in connection with the acquisition of AMDB. Pro forma results of operations as if this acquisition had occurred at the beginning of 2002 and 2003 are not shown because its impact would have been immaterial.

6. Business Divestitures

Gaming Systems International

On June 19, 1999, the Company sold Gaming Systems International (GSI) for an amount in excess of the book value of net assets sold. Assets sold of approximately \$3,749,000 consisted of accounts receivable of \$1,514,000, inventories of \$364,000, furniture, fixtures and equipment of \$218,000, intangible assets of \$1,573,000 and prepaid expenses of \$80,000. Liabilities assumed by the buyer consisted of accounts payable and accrued liabilities of \$197,000, deposits of \$100,000, unearned revenue of \$351,000 and long-term debt of \$446,000. The Company received three promissory notes totaling \$4,925,000 with face values of \$1,100,000, \$1,500,000 and \$2,325,000, respectively. Interest was paid monthly at the rate of 10% per annum on both the \$1,100,000 and \$1,500,000 notes, with the principal due and payable on June 19, 2001 and June 19, 2003, respectively. A third party guaranteed the \$1,100,000 promissory note. Principal payments and interest, at prime plus 1%, was to commence for the \$2,325,000 promissory note on October 1, 2002 in 48 monthly installments of approximately \$48,000 of principal, plus accrued interest.

Imputing interest at a rate of 10%, the present value of the \$2,325,000 promissory note at the date of sale was \$1,682,000, which resulted in a combined carrying value of \$4,282,000 for all three promissory notes. The gain on sale of \$1,227,000 had been deferred until collection of the proceeds representing the gain can be assured. As of December 31, 2000, the Notes were held for sale and were written down to an amount, which approximated their estimated net realizable value of \$2,700,000.

On April 6, 2001 the Company entered into an agreement with the maker of the Notes whereby the maker reconvened 100% of the Common Stock of GSI to the Company. For the purpose of selling GSI to a third party. In connection with the agreement, the Company canceled the Notes and entered into a new \$1.1 million secured promissory note with the same party. The maker will be paid a commission of 30% of cash receipts from the third party, which will be first applied to the \$1.1 million note and paid in cash to the maker thereafter. On July 27, 2001, the Company entered into an Asset Purchase Agreement (Agreement) with the third party for approximately \$3.2 million whereby all of the assets of GSI were acquired and all of the liabilities assumed, except for approximately \$300,000 of obligations, which will remain with GSI. The payment terms under the Agreement required a \$1 million non-refundable cash payment to the Company, which was received on July 27, 2001 and a \$1.5 million payment, which was received in December 2001. The Company also received a secured promissory note in the amount of \$750,000, of which \$500,000 was received in December 2002 and \$250,000 in January 2003. The third party was also required to pay an additional \$250,000 subject to a maximum \$250,000 reduction pursuant to the resolution of certain uncertainties as of the date of the Agreement, which, as part of the settlement, in January 2003 the Company received \$46,000. Due to the uncertainty of collecting the unsecured amount of

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

\$250,000, gain recognition on that part of the proceeds was deferred until collection was assured. The Company recorded a gain on the sale of GSI of \$245,000 in the fourth quarter of 2001.

Legacy

On October 9, 2001, the Company sold certain rights under customer contracts together with the related assets and liabilities of its domestic Legacy hardware maintenance division to the third party currently providing the on-site repair and warranty service to the Company's Legacy hardware maintenance customers. Pursuant to the agreement, the Company retained the software maintenance component of the customer contracts and will continue to provide the

software support services directly to the domestic Legacy customer base. Additionally, the third party will be required to pay the Company approximately 15% of the third party's hardware maintenance revenue stream relating to the hardware maintenance customer contracts subsequent to October 31, 2003. In connection with the sale, the Company received \$328,000 in cash and sold approximately \$157,000 of assets consisting of inventory, spare parts, fixed assets and certain accounts receivable. The third party also assumed approximately \$1,091,000 of liabilities consisting of accrued liabilities of approximately \$366,000 and deferred revenue of approximately \$725,000. The sale resulted in a gain of approximately \$1,262,000 in October 2001.

MAI Canada

On December 6, 2002, the Company sold all the assets and certain liabilities of its Canadian operations, including all legacy divisions, to the management of this subsidiary pursuant to a stock purchase agreement. In connection with the sale, the Company also entered into a software distribution agreement whereby the buyer has a non-exclusive right and license to market and install the Company's hospitality products in Canada. The sale resulted in a loss of approximately \$630,000, which is included in the loss on disposal of discontinued operations. Prior to the sale, the Canadian operations incurred a net income of \$5,000 and \$178,000 for the three-month and nine-month periods ended September 30, 2002, respectively.

Process Manufacturing

On December 6, 2002, the Company entered into an Asset Purchase Agreement whereby all the assets and certain liabilities of its process manufacturing software division were sold to a third party for cash of \$250,000. The sale resulted in a loss of approximately \$391,000, which is included in the loss on disposal of discontinued operations. Prior to the sale, Process Manufacturing operations incurred a net loss of \$203,000 and \$215,000 for the three-month and nine-month periods ended September 30, 2002.

7. Line of Credit and Bridge Loan and Long Term Debt

Line of Credit & Bridge Loan

On July 28, 1999, the Company obtained a Bridge Loan from Coast Business Credit (Coast) in the amount of \$2,000,000. The Bridge Loan originally bore interest at prime plus 5% (prime plus 8% when default interest rates apply). Loan origination fees of \$75,000 paid to Coast in connection with the Bridge Loan were amortized to interest expense over the term of the loan. During the first quarter of 2001, the remaining balance of the Bridge Loan was repaid in full. In April 1998, the Company negotiated a \$5,000,000 secured revolving credit facility with Coast. The availability of this facility was based on a calculation using a rolling average of certain cash collections. The facility is secured by all assets, including intellectual property of the Company, and bore interest at prime plus 4.5% and was due to expire on April 30, 2003. The credit facility was amended to allow for aggregate borrowings on an interest only basis under the credit facility not to exceed \$3,360,000. In connection with the amendment, the Company agreed to pay Coast a fee of \$300,000 (Loan Fee) in weekly installments of \$35,000 commencing after the Bridge Loan was paid in full. The Loan Fee was fully paid by April 23, 2001. The Loan Fee of \$300,000 is classified in prepaid and other current assets and was being amortized to interest expense over the original term of the facility. The loan fee was fully amortized in the first quarter of 2003.

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

On January 13, 2003, the Company re-negotiated the terms of the credit facility whereby the outstanding balance of \$1,828,000. As of that date was converted to a term loan which accrues interest at 9.25% per annum and requires monthly payments of \$58,000 over a 36 months period commencing March 1, 2003. The new term loan matures on February 28, 2005, at which time all remaining principal and accrued interest is due and payable. The Company will also be required to pay Coast additional principal payments on a quarterly basis based upon an EBITDA-based formula commencing March 31, 2003. For the three-months ended September 30, 2003, there are no additional principal payments required under the EBITDA-based formula. The consolidated balance sheet as of December 31, 2002 and September 30, 2003 reflects the re-class of the secured revolving credit facility to a term loan.

On February 7, 2003, the Federal Deposit Insurance Corporation (FDIC) put Coast and its parent company, Southern Pacific Bank, into receivership and held all of Coast's assets for sale to third parties. On May 15, 2003, the loan was sold to Wamco 31, Ltd. (Wamco). This sale of the loan by the FDIC did not change any of the terms of the Company's loan agreement.

The restructured debt, pursuant to the original inter-creditor agreement between Canyon Capital and Coast, which was sold to Wamco on May 15, 2003, contains various restrictions and covenants, including a minimum quick ratio of 0.31

to 1.00 and minimum debt service coverage ratio of 1.25 to 1.00 for the three-month period ended September 30, 2003. The minimum quick ratio increases to .34 to 1.00 as of December 31, 2003 and for each and every fiscal quarter ending thereafter. In the event that the Company were not in compliance with the various restrictions and covenants and were unable to receive waivers for non-compliance, the term debt would be immediately due and payable. The Company was not in compliance with its minimum quick ratio but received a waiver for such covenant as of and for the three month period ended September 30, 2003. There is no guaranty that the Company will meet its debt covenants in the future. The Company is currently negotiating with Wamco to change such covenants, but there is no assurance that the Company will be able to successfully change the covenants.

Long-Term Debt

In March 1997, the Company issued \$6,000,000 of 11% subordinated notes payable due in 2004 to an investment fund managed by Canyon Capital Management LP (Canyon). In September 1997, this indebtedness was reduced to \$5,250,000 through application of a portion of the proceeds realized from the exercise of warrants by Canyon. The notes called for semi-annual interest payments.

The Company and Canyon subsequently entered into a forbearance agreement providing that the Company pays Canyon weekly interest payments of \$12,500 effective January 1, 2000. In addition, the Company executed a security agreement, which provided Canyon with a lien on all of the Company's tangible and intangible property, which lien is junior to the lien granted to Wamco.

On April 13, 2000, the Company entered into an agreement with Canyon, waiving all existing events of default, accelerated the maturity date to March 3, 2003 and provided for continued weekly interest payments of \$12,500. On January 31, 2001, the Company entered into an agreement with Canyon whereby the specified accrued interest of \$431,000 was added to the principal balance of the subordinated notes payable. As part of this agreement, the Company also agreed to pay Canyon an additional \$79,000 loan fee, of which \$29,000 was added to principal. The principal balance outstanding on the subordinate notes payable to Canyon was approximately \$5,662,000 at December 31, 2002 and September 30, 2003.

On January 13, 2003, the Company modified the terms of its agreement with Canyon, whereby the Company is required to make monthly payments of \$52,000 until the Wamco term loan is paid off in full at which time the note payable will be converted into a three-year amortizing loan which will accrue interest at 11% per annum and requires equal monthly payments of principal and interest such that the subordinated debt will be paid in full at the end of the amended term. Upon the repayment of the Wamco debt in full, the Company will also be required to pay Canyon additional principal payments on a quarterly basis based upon an EBITDA-based formula. Additionally, the Company issued to Canyon 200,000 shares of its common stock valued at \$20,000 (the quoted market price of the common stock at the time the terms were agreed) and agreed to issue one million warrants at an exercise price of \$0.40 per share valued at \$42,000 (using the Black-Scholes option-pricing model with the following weighted-average assumptions: risk-free interest rate of 6.5%, volatility of 80% and an expected life of 5 years). The \$62,000 is being amortized to interest expense over the term of the modified note.

In connection with a settlement agreement with CSA, the Company issued \$2.8 million of subordinated debt to CSA. The \$2.8 million of debt is secured by all of the Company's assets, which is subordinate to Wamco and Canyon, accrues interest at 10% per annum and requires payments of \$37,500 from March 1, 2002 through September 1, 2002 and monthly payments of \$107,500 commencing on October 1, 2002 until October 2003 when all remaining unpaid principal and accrued interest is to be paid in full. The balance outstanding on the subordinate debt to CSA was \$2,800,000 at December 31, 2002 and September 30, 2003.

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

The agreement with CSA was amended whereby the Company shall be required to pay the required payments under the subordinated note unless and until it paid \$1 million by December 31, 2002. Upon payment of the \$1 million, contractual payments under the subordinated note would have ceased until a final payment in the amount of \$400,000 is paid by February 28, 2003. If the Company did not make all of the modified payments to CSA, the subordinated note will revert back to its original terms. The Company did not make the modified payment and have not made any payments since September 2002. Under the terms of the subordination agreement between Wamco, Canyon and CSA, the Company is not allowed to make any principal or interest payments to CSA until the Wamco and Canyon debt, including any accrued interest, is repaid in full or the CSA debt is restructured and approved by Wamco and Canyon. The Company is currently in negotiations with CSA to restructure the terms of the subordinated notes including extending its maturity date. There can be no assurance that CSA and MAI will come to terms on a restructuring or that Wamco and Canyon will ultimately approve the terms of the restructuring. In the event that the Company is unable to meet the required payments to its primary lenders or meet its payment obligations to its other secured creditors, they are entitled to exercise certain rights under the respective agreements the Company has with them, including but not limited to, foreclosing on all of the Company's tangible and intangible assets. Such action would have a substantial adverse effect on our ability to continue as a going concern. The CSA debt is shown as current.

CSA has not formally notified the Company of its default. As of December 31, 2002 and September 30, 2003, accrued interest relating to the CSA subordinated debt was \$408,000 and \$657,000 respectively, and is included in accrued liabilities in the accompanying consolidated balance sheets.

8. Common Stock

In January and February of 2001, the Company entered into agreements with several creditors to retire approximately \$2.1 million of Company obligations in exchange for 798,000 shares of Common Stock and \$470,000 of cash. This resulted in a gain of \$1,377,000. To fulfill its performance under the agreement, the Company issued the 798,000 shares of its Common Stock and registered the shares with the SEC. The Company must also pay the \$470,000 to the creditors as prescribed in the respective agreements. All payments required under the agreements were made in 2001 and the first quarter of 2002.

In May 2002, the Company issued 612,500 shares of restricted common stock to its members of the board of directors and certain of its corporate officers. Recipients are not required to provide consideration to the Company other than rendering the service and have the right to vote the shares.

Under SFAS No. 123, compensation cost is recognized for the fair value of the restricted stock awarded, which is its fair market value without restrictions at the date of grant, which was \$0.25 per share. The total market value of the shares of \$153,125 was treated as unearned compensation and is being amortized to expense in proportion to the vesting schedule through March 2005. The unamortized balance as of September 30, 2003 is \$62,000.

9. Preferred Stock

On May 20, 1997, the Company authorized the issuance of up to 1,000,000 shares of \$0.01 par value preferred stock. The Board of Directors has the authority to issue the preferred stock, in one or more series, and to fix the rights, preferences, privileges and restrictions thereof without any further vote by the holders of Common Stock.

10. Intangible Assets

Intangible assets consist primarily of goodwill and capitalized software. Intangible assets other than goodwill are amortized on a straight-line basis over their estimated useful lives. Prior to 2002, goodwill, representing the excess of the purchase price over the estimated fair value of the net assets of the acquired business, was amortized over the period of expected benefit of five to seven years. However, effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, (SFAS No. 142) which requires that the Company cease amortization of all goodwill and intangible assets having indefinite useful economic lives. The Company determined that there was no impairment upon adoption. Such assets are not to be amortized until their lives are determined to be finite. However, a recognized intangible asset with an indefinite useful life should be tested for impairment annually or on an interim basis if events or circumstances indicate that the fair value of the asset has decreased below its carrying value. The Company will evaluate its goodwill

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

as of December 31, 2003 and determined that fair value had not decreased below carrying value and no adjustment to impair goodwill was necessary in accordance with SFAS No. 142.

Goodwill and capitalized software as of December 31, 2002 and September 30, 2003 are as follows:

	(dollars in thousands)	
	December 31, 2002	September 30, 2003
Goodwill	\$ 962	\$ 1,121
Accumulated amortization		
Goodwill, net	962	1,121
Capitalized software	861	1,480
Accumulated amortization		
Capitalized software, net	861	1,480
Total	\$ 1,823	\$ 2,601

The Company's weighted average amortization period for capitalized software is expected to be three years. The following table shows the estimated amortization expense for these assets for each of the five succeeding years:

Year Ending December 31,

(in thousands)

2003	\$	
2004		493
2005		493
2006		494
2007		
2008	\$	1,480

11. Income (Loss) Per Share of Common Stock

Basic and diluted income or loss per share is computed using the weighted average shares of common stock outstanding during the period. Consideration is also given in the diluted income per share calculation for the dilutive effect of stock options and warrants.

The following table illustrates the computation of basic and diluted earnings per share under the provisions of SFAS 128:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2002	2003	2002	2003
	(in thousands except per share data)		(in thousands except per share data)	
Numerator:				
Numerator for basic and diluted earnings (loss) per share				
net income (loss)	\$ (163)	\$ 132	\$ 509	\$ 310
Denominator:				
Denominator for basic earnings (loss) per share				
weighted average number of Common shares outstanding during the period	14,119	14,575	13,876	14,525
Incremental common shares attributable to exercise of outstanding shares	450	300	450	300
Denominator for diluted earnings (loss) per share	14,569	14,875	14,326	14,825
Basic earnings (loss) per share	\$ (0.01)	\$ 0.01	\$ 0.04	\$ 0.02
Diluted earnings (loss) per share	\$ (0.01)	\$ 0.01	\$ 0.04	\$ 0.02

The number of anti-dilutive options and warrants that were excluded from the computation of incremental common shares were 2,667,272 and 3,041,500 for the nine month period ended September 30, 2002 and 2003, respectively.

12. Stock Option Plans

The Company accounts for stock-based compensation in accordance with Accounting Principles Board, APB, No. 25, Accounting for Stock Issued to Employees. The Company has adopted the disclosure-only provisions of FAS No. 123 Accounting for Stock-Based Compensation. Under APB No. 25, compensation expense relating to employee stock options is determined based on the excess of the market price of the Company's stock over the exercise price on the date of grant, the intrinsic value method, versus the fair value method as provided under FAS No. 123.

In December 2002, the FASB issued FAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which amended FAS No. 123, Accounting for Stock-Based Compensation. The new standard provides alternative methods of transition for a voluntary change to the fair market value based method for accounting for stock-based employee compensation. Additionally, the statement amends the disclosure requirements of FAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. This statement is effective for financial statements for the year ended December 31, 2002. In compliance with FAS No. 148, the Company has elected to continue to follow the intrinsic value method in accounting for its stock-based employee compensation plan as defined by APB No. 25.

At September 30, 2003, the Company had two stock-based employee compensation plans. The Company accounts for that plan under the recognition and measurement principles of APB No. 25, Accounting for Stock Issued to Employees, and related interpretations. Accordingly, no stock-based employee compensation cost is reflected in net income (loss), as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. Had compensation cost for the Company's stock option plan been determined

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

based on the fair value at the grant date for awards for the three-month periods ended September 30, 2002 and 2003, consistent with the provisions of FAS No. 123, the Company's net income (loss) and net income (loss) per share would have decreased. The following table represents the effect on net income and net income per share if the Company had applied the fair value based method and recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

	For the three-months ended September 30, (in thousands, except per share data)		For the nine-months ended September 30, (in thousands, except per share data)	
	2002	2003	2002	2003
Net income (loss):				
As reported	\$ (163)	\$ 132	\$ 509	\$ 310
Add: Stock-based employee compensation expense recorded				
Less: Stock based employee compensation expense determined under fair value calculations	(33)	(17)	(99)	(51)
Pro forma	\$ (196)	\$ 115	\$ 410	\$ 259
Basic income (loss) per share:				
As reported	\$ (0.01)	\$ 0.01	\$ 0.04	\$ 0.02
Add: Stock-based employee compensation expense recorded				
Less: Stock based employee compensation expense determined under fair value calculations			(0.01)	
Pro forma	\$ (0.01)	\$ 0.01	\$ 0.03	\$ 0.02
Diluted income (loss) per share:				
As reported	\$ (0.01)	\$ 0.01	\$ 0.04	\$ 0.02
Add: Stock-based employee compensation expense recorded				
Less: Stock based employee compensation expense determined under fair value calculations			(0.01)	
Pro forma	\$ (0.01)	\$ 0.01	\$ 0.03	\$ 0.02

13. Legal Proceedings

Internal Revenue Service

On September 30, 2003, the Company entered into a settlement agreement with the United States Internal Revenue Service (the Service) on a tax claim which resulted from the Company's Chapter 11 proceedings whereby it agreed to pay an aggregate of \$489,000 in equal monthly installments of \$7,438 over a period of six (6) years at an interest rate of 6%. The \$489,000 settlement is reflected as debt in the financial statements. The settlement resulted in a one-time gain of \$262,000 which is reflected in other operating income. In the event that the Company fails to pay the Service any payment, and such payment failure continues for sixty days after written notice of such failure, \$1,832,100, plus

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

accrued interest thereon, less any payments made by the Company will be immediately due and payable to the Service.

CSA Private Limited

CSA is a MAI shareholder. On August 9, 1996, MAI acquired from Hotel Information Systems, Inc. (HIS)

substantially all their assets and certain of their liabilities (the HIS Acquisition). At the time of MAI's acquisition of HIS in 1996, CSA was a shareholder of HIS and, in connection with the purchase, MAI agreed to issue to CSA shares of its Common Stock worth approximately \$4.8 million in August 1996, which amount had increased to approximately \$6.8 million as of December 31, 2000, pursuant to the agreement. The Company entered into a settlement agreement with CSA in February, 2001 whereby it (i) issued CSA 1,916,014 additional shares of our Common Stock to bring CSA's total share ownership to 2,433,333 shares; (ii) filed a registration statement for all of CSA's shares of our Common Stock which has been declared effective by the SEC so that such shares are now freely tradable; and (iii) executed a secured debt instrument in favor of CSA in the principal sum of \$2,800,000 which is subordinate only to the Company's present group of two (2) senior secured lenders and required cash installment payments to commence in March 2002.

In connection with the settlement agreement with CSA, the Company recorded the \$2.8 million debt issuance as a reduction in paid in capital and the 1,916,014 additional shares at par as an addition to Common Stock and a reduction to additional paid in capital.

Cher-Ae Heights Indian Community

A lawsuit was filed by Cher-Ae Heights Indian Community (Cher-Ae Heights) against Logix Development Corporation (Logix). Now known as MAI Development Corporation, as a co-defendant for a breach of contract by the Company's formerly owned gaming subsidiary along with the new owners, Monaco Informatiques Systemes (MIS), who acquired the assets and certain liabilities of the gaming subsidiary on July 27, 2001. Based upon this suit, MIS informed the Company that it did not intend to pay the next \$500,000 due to the Company under a promissory note and security agreement. On October 24, 2002, the Company entered into a global settlement agreement between the parties whereby all claims, known and unknown, between the parties were dismissed and the Company received \$796,000.

Logix Development Corporation

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

The Company entered into a settlement agreement with Logix in July of 2002 whereby it (i) issued Logix 200,000 shares of our Common Stock (ii) required the Company to make various cash installment payments totaling \$175,000 to be paid within 1 year and (iii) executed a contract with Logix for a consulting project in the amount of \$50,000.

Other Litigation

The Company is also involved in various other legal proceedings and claims that are incident to its business. Management believes that the ultimate outcome of these matters will not have a material adverse effect on the consolidated financial position, results of operations or liquidity of the Company.

14. Comprehensive Income

The following table summarizes components of comprehensive income:

	For The Three Months Ended September 30,		For The Nine Months Ended September 30,	
	2002	2003	2002	2003
Net income (loss)	\$ (163)	\$ 132	\$ 509	\$ 310
Change in cumulative translation adjustments	(37)	(11)	(128)	28
Comprehensive income (loss)	\$ (200)	\$ 121	\$ 381	\$ 338

Accumulated other comprehensive income in the accompanying consolidated balance sheets consists of cumulative translation adjustments.

Item 2. Management's Discussion And Analysis Of Financial Condition And Results Of Operations

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect our reported assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our

estimates, including those related to revenue recognition, accounts receivable and intangible assets. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. This forms the basis of judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies and the related judgments and estimates affect the preparation of our consolidated financial statements:

Revenue Recognition

The Company earns revenue from sales of hardware, software and professional services and from arrangements involving multiple elements of each of the above. Revenue for multiple element arrangements are recorded by allocating revenue to the various elements based on their respective fair values as evidenced by vendor specific objective evidence. The fair value in multi-element arrangements is determined based upon the price charged when sold separately. Revenue is not recognized until persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable and collectibility is probable. Sales of network and computer equipment are recorded when title and risk of loss transfers. Software revenues are recorded when application software programs are shipped to end users, resellers and distributors, provided the Company is not required to provide services essential to the functionality of the software or significantly modify, customize or produce the software. Professional services fees for software development, training and installation are recognized as the services are provided. Maintenance revenues are recorded evenly over the related contract period.

Allowance for Doubtful Accounts

The Company records an allowance for doubtful accounts based on specifically identified amounts that it believes is uncollectible. The Company also records additional allowances based upon certain percentages of our aged receivables, which are determined based on historical experience and or assessment of the general financial conditions affecting our customer base. If the Company's actual collection experience changes, revisions to its allowance may be required. Any unanticipated change in the Company's customer's credit worthiness or other matters affecting the collectibility of amounts due from such customers, could have a material affect on its results of operations in the period in which such changes or events occur. After all attempts to collect a receivable have failed, the receivable is written off against the allowance.

Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed Of

Statement of Financial Accounting Standards (SFAS) No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" provides a single accounting model for long-lived assets to be disposed of. SFAS No. 144 also changes the criteria for classifying an asset as held for sale, and broadens the scope of businesses to be disposed of that qualify for reporting as discontinued operations and changes the timing of recognizing losses on such operations.

The Company adopted SFAS No. 144 on January 1, 2001. The adoption of SFAS No.144 did not affect the Company's financial statements. In accordance with SFAS No. 144, long-lived assets, such as furniture, fixtures and equipment are reviewed for impairment whenever events or

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, and impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the balance sheet.

Prior to the adoption of SFAS No. 144, the Company accounted for long-lived assets to be disposed of in accordance with SFAS No. 121, Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of .

Goodwill

Prior to 2002, goodwill, representing the excess of the purchase price over the estimated fair value of the net assets of the acquired business, was amortized over the period of expected benefit of five to seven years. Long-lived assets and certain identifiable intangibles to be held and used by the Company were reviewed for impairment whenever events or changes in circumstances indicated that the carrying amount of the asset may not be recoverable. Recoverability of

assets to be held and used was assessed by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets were considered to be impaired, the impairment recognized was measured by the amount by which the carrying amount of the assets exceeded the fair value of the assets. Assets that were to be disposed of were reported at the lower of the carrying amount or fair value less cost to sell.

However, effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, (SFAS No. 142) which requires that the Company cease amortization of goodwill and all intangible assets having indefinite useful economic lives. Such assets are not to be amortized until their lives are determined to be finite. However, a recognized intangible asset with an indefinite useful life should be tested for impairment annually or on an interim basis if events or circumstances indicate that the fair value of the asset has decreased below its carrying value. The Company evaluates its goodwill annually in December.

Software Development Costs

The Company capitalizes costs related to the development of certain software products. Capitalization of costs begins when technological feasibility is established and ends when the product is available for general release to customers. Technological feasibility is reached upon the earlier of completion of a detailed program design or working model.

Amortization is computed on an individual product basis and is recognized over the greater of the remaining economic lives of each product or the ratio that current gross revenues for a product bear to the total of current and anticipated revenues for that product, commencing when the products become available for general release to customers. Software development costs are generally being amortized over a three-year period. The Company continually assesses the recoverability of software development costs by comparing the carrying value of individual products to their net realizable value.

The Company capitalized \$615,000 and \$619,000 for the nine-month period ended September 30, 2002 and 2003, respectively for software development costs relating to its new N-Tier, Internet-native corporate application suite of products written in java. Although the Company has not yet sold any of the modules to this suite of applications, the Company believes that its new product will produce new sales adequate to recover amounts capitalized.

Reclassifications

Certain prior year amounts have been reclassified to conform with the 2003 presentation.

Liquidity and Capital Resources

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

At September 30, 2003, working capital decreased from a working capital deficiency of \$8,649,000 at December 31, 2002 to a working capital deficiency of \$9,798,000. Excluding unearned revenue of \$3,483,000, the Company's working capital deficiency at September 30, 2003 would be \$6,315,000. Excluding unearned revenue of \$3,693,000, the Company's working capital deficiency at December 31, 2002 would be \$4,956,000. Excluding unearned revenue, the decrease in the working capital deficiency of \$1,359,000 was primarily attributable decrease in accounts payable of \$213,000 offset by decreases in cash of \$384,000, net accounts receivable of \$119,000, note receivable of \$250,000 and increases in current portion of long term debt of \$217,000, customer deposits of \$152,000 and accrued liabilities of \$459,000.

Net cash used in investing activities for the period ended September 30, 2003 totaled \$688,000, which is comprised of capital expenditures of \$240,000, capitalized software of \$619,000 and acquisition of unconsolidated subsidiary of \$79,000 offset by proceeds from note receivable of \$250,000.

Net cash used in financing activities for the period ended September 30, 2003 totaled \$312,000, which represents repayments on long-term debt. On January 13, 2003, the Company converted its credit facility to a term loan which requires monthly principal and interest payments of \$58,000 and matures on February 28, 2005. In addition, the Company amended its subordinated note to require monthly interest only payments of \$52,000 through February 28, 2005, at which time it will convert to a term loan to be amortized over a three years period. The restructured debt, pursuant to the original intercreditor agreement between Canyon and Coast, which was sold to Wamco on May 15, 2003, contains various restrictions and covenants, including a minimum quick ratio of 0.31 to 1.00 and minimum debt service coverage ratio of 1.25 to 1.00 for the three-month period ended September 30, 2003. The minimum quick ratio increases to 0.34 to 1.00 as of December 31, 2003 and for each and every fiscal quarter ending thereafter. In the event that we were not in compliance with the various restrictions and covenants and were unable to receive waivers for non-compliance,

the term debt would be immediately due and payable. The Company was not in compliance with and received a waiver for its minimum quick ratio covenant as of and for the three-month period ended September 30, 2003. There is no guaranty that the Company will meet its debt covenants in the future. The Company is currently negotiating with Wamco to change such covenants, but there is no assurance that the Company will be able to successfully change the covenants.

Stockholders' deficiency decreased from \$14,782,000 at December 31, 2002 to \$14,551,000 at September 30, 2003, mainly as a result of net income during the period of \$310,000, the issuance of common stock and warrants to Canyon Capital valued at \$62,000, and amortization of unearned compensation of \$29,000 offset by a reduction in additional paid-in capital of \$199,000 relating to the issuance of \$149,000 of debt and \$50,000 of cash to satisfy a legal settlement (see note 5).

Although the Company has a net stockholders' deficiency of \$14,551,000 and a working capital deficit of \$9,798,000. (which includes subordinated debt due to CSA of \$2,800,000) at September 30, 2003, the Company believes it will generate sufficient funds from operations and obtain additional financing or restructure its subordinated note with CSA to meet its operating and capital requirements. The Company is currently in negotiations with CSA to restructure the terms of the existing debt, including extending the maturity date. The Company expects to generate positive cash flow from its continuing operations during 2003 from shipping out products and services from its current backlog as of September 30, 2003 as well as new orders. In the event that the Company cannot generate positive cash flow from its continuing operations during 2003, the Company can substantially reduce its research and development efforts to mitigate cash outflow to help sustain its operations. There can be no assurance that the Company will be able to sustain profitability, generate positive cash flow from operations or restructure its debt as necessary. These financial statements have been prepared assuming the Company will continue to operate as a going concern. If the Company is unsuccessful in the aforementioned efforts, the Company could be forced to liquidate certain of its assets, reorganize its capital structure and, if necessary, seek other remedies available to the Company, including protection under the bankruptcy laws.

Contractual Obligations and Commercial Commitments

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

The following table summarizes the Company's obligations and commitments as of September 30, 2003:

Contractual Cash Obligations	Total	Payments Due by Period (in thousands)			
		Less Than 1 Year	1-3 Years	4-5 Years	After 5 Years
Long-Term Debt	\$ 10,699	\$ 3,507	\$ 3,948	\$ 2,992	\$ 252
Operating Leases	1,978	596	1,064	239	79
Consulting Agreements	360	360			
	\$ 13,037	\$ 4,463	\$ 5,012	\$ 3,231	\$ 331

Results of Operations

Three Months Ended September 30, 2002 Compared to Three Months Ended September 30, 2003

	September 30, 2002 (in thousands)	Percentage of Revenue	September 30, 2003 (in thousands)	Percentage of Revenue
Revenue:	\$ 5,711	100.0%	\$ 4,814	100.0%
Gross profit	3,911	68.5%	3,465	71.9%
Selling, general and administrative expenses	2,404	42.0%	2,307	47.9%
Research and development costs	797	14.0%	764	15.9%
Amortization of intangibles	25	0.4%		
Other operating expense (income)	232	4.1%	(134)	(2.8)%
Interest expense, net	372	6.5%	286	5.9%
Other non-operating expense	14	0.2%	98	2.0%
Income tax expense	8	0.1%	12	0.2%
Loss from discontinued operations	(223)	(3.9)%		
Net income (loss)	\$ (163)	(2.9)%	\$ 132	2.7%

Revenue for 2003 was \$4,814,000 compared to \$5,711,000 in 2002 or a 18.6% decrease. Revenue decreased \$897,000 in 2003, as a result of decreased professional services and maintenance services due to decreased capital spending on information technology in 2003 mainly due to the effects of the September 11, 2001 terrorist attacks on the hospitality industry.

The decrease in revenue in 2003 was mainly attributable to a decrease in service volume and rates as many hotels have reduced their operating costs by canceling or reducing contracted services, including support, in a post September 11, 2001 economy. Many hotels have requested that their suppliers reduce the cost of service or delay any price increases while they are experiencing reduced guest occupancy and lower average daily rates on their inventory of rooms. Certain hotels have also established their own help desks to further reduce costs. As a result, the Company postponed increasing its support prices until the first quarter of 2003 and agreed, with certain of its clients, to provide a second line of support versus a first line of support that was previously provided to such clients. Our continuing hospitality business is expected to generate sufficient cash from operations to adequately fund its ongoing operating activities.

Gross profit for 2003 decreased to \$3,465,000 from \$3,911,000 in 2002. The decrease in gross profit is mainly due to the decrease in software and maintenance services revenues which was offset by the Company's cost reductions during the period.

Selling, general and administrative expenses (SG&A) decreased slightly from \$2,404,000 in 2002 to \$2,307,000 in 2003 as a result of continued efforts to reduce costs.

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

Research and development costs decreased from \$797,000 in 2002 to \$764,000 in 2003. The Company capitalized \$257,000 and \$200,000 of software development costs in 2002 and 2003, respectively, associated with the Company's product development of its new internet native suite of applications.

The decrease in amortization of intangibles in 2003 versus the comparable period of 2002 is due to the fact that the Company amortized \$25,000 of software development costs in 2002 relating to costs capitalized in 1999. These costs were fully amortized during 2002.

Net interest expense was \$372,000 in 2002 compared to \$286,000 in 2003. The decrease is due to lower balances of interest bearing debt and lower interest rates on variable debt during 2003 as compared to 2002.

Other operating expense (income) in 2002 was \$232,000 compared to (\$134,000) in 2003. Other operating income in 2003 was mainly due to a settlement agreement related to a disputed tax claim by the United States Internal Revenue Service that resulted in a one-time gain of \$262,000 (see note 13).

Other non-operating expense increased from \$14,000 in 2002 to \$98,000 in 2003. Non-operating expense relates to pension expense under a defined benefit plan for former employees from our discontinued operations.

Results from discontinued operations were \$223,000 in 2002. Results from discontinued operations in 2003 were \$0 as all entities held for sale were sold in the fourth quarter of 2002.

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

Nine Months Ended September 30, 2002 Compared to Nine Months Ended September 30, 2003

	September 30, 2002 (in thousands)	Percentage of Revenue	September 30, 2003 (in thousands)	Percentage of Revenue
Revenue	\$ 16,931	100.0%	\$ 14,752	100.0%
Gross profit	11,370	67.2%	10,705	72.6%
Selling, general and administrative expenses	6,787	40.0%	7,277	49.3%
Research and development costs	2,461	14.6%	2,104	14.3%
Amortization of intangibles	134	0.8%		
Other operating expense (income)	237	1.4%	(181)	(1.2)%
Interest expense, net	1,142	6.8%	927	6.3%
Other non-operating expense	41	0.2%	309	2.1%
Income tax expense (benefit)	16	0.1%	(41)	(0.3)%
Loss from discontinued operations	(43)	(0.3)%		
Net income	\$ 509	3.0%	\$ 310	2.1%

Revenue for 2003 was \$14,752,000 compared to \$16,931,000 in 2002 or a 12.9% decrease. Revenue decreased \$2,179,000 in 2003, as a result of decreased professional services and maintenance services due to decreased capital spending on information technology in 2003 mainly due to the effects of the September 11, 2001 terrorist attacks on the hospitality industry.

The decrease in revenue in 2003 was mainly attributable to a decrease in service volume and rates as many hotels have reduced their operating costs by canceling or reducing contracted services, including support, in a post September 11, 2001 economy. Many hotels have requested that their suppliers reduce the cost of service or delay any price increases while they are experiencing reduced guest occupancy and lower average daily rates on their inventory of rooms. Certain hotels have also established their own help desks to further reduce costs. As a result, the Company postponed increasing its support prices until the first quarter of 2003 and agreed, with certain of its clients, to provide a second line of support versus a first line of support that was previously provided to such clients. Our continuing hospitality business is expected to generate sufficient cash from operations to adequately fund its ongoing operating activities.

Revenue in our Asian operations increased from \$1,797,000 in 2002 to \$2,111,000 in 2003 as a result of its acquisition of HSS in June 2002 (see note 5) which allowed the Company to expand its operations in the Asian marketplace, strengthen its management team in the territory and create new opportunities for its new enterprise capable suite of products.

Gross profit for 2003 decreased to \$10,705,000 (72.6%) from \$11,370,000 (67.2%) in 2002. The decrease in gross profit is mainly due to the decrease in software and maintenance services revenues which was offset by the Company's cost reductions during the period.

Selling, general and administrative expenses (SG&A) increased from \$6,787,000 in 2002 to \$7,277,000 in 2003. The increase is mainly due to an increase in selling and marketing expenses for trade shows, advertisement and travel as the Company continues to actively and aggressively market its newly developed enterprise suite of applications and services.

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

Research and development costs decreased from \$2,461,000 in 2002 to \$2,104,000 in 2003. The decrease is due to the capitalization of \$615,000 and \$619,000 of software development costs in 2002 and 2003, respectively, associated with the Company's product development of its new internet native suite of applications. The decrease is also due to a decrease in headcount associated with the Company's focus on reducing costs.

Other operating expense (income) was \$237,000 in 2002 and (\$181,000) in 2003. Other operating income in 2003 is due to receipt of approximately \$46,000 of cash resulting from a legal settlement and a settlement agreement on a tax claim with the United States Internal Revenue Service that resulted in a one-time gain of \$262,000 (see note 13).

The decrease in amortization of intangibles in 2003 versus the comparable period of 2002 is due to the fact that the Company amortized \$134,000 of software development costs in 2002 relating to costs capitalized in 1999. These costs were fully amortized during 2002.

Net interest expense was \$1,142,000 in 2002 compared to \$927,000 in 2003. The decrease is due to lower balances of interest bearing debt and lower interest rates on variable rate debt during 2003 as compared to 2002.

Other non-operating expense increased from \$41,000 in 2002 to \$309,000 in 2003. Non-operating expense relates to pension expense under a defined benefit plan for former employees from our discontinued operations.

The income tax provision (benefit) only reflects a tax provision for our foreign operations and alternative minimum taxes for domestic operations due to the utilization for net operating loss carry forward. The income tax benefit in 2003

is due to the Company recording a domestic income tax receivable during the period to recover taxes previously paid.

Results from discontinued operations was \$43,000 in 2002. Results from discontinued operations in 2003 was \$0 as all entities held for sale were sold in the fourth quarter of 2002.

Item 3. Quantitative And Qualitative Disclosures About Market Risk

Market Risk Disclosures

The following discussion about our market risk disclosures contains forward-looking statements. Forward-looking statements are subject to risks and uncertainties. Actual results could differ materially from those discussed in the forward-looking statements. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not have derivative financial instruments for hedging, speculative, or trading purposes.

Interest Rate Sensitivity

Of our \$10.7 million principal amount of indebtedness at September 30, 2003, none bears interest at a variable rate. However, \$5.7 million bears interest at a fixed rate of 11%, \$2.8 million bears interest at a fixed rate of 10%, \$1.6 million bears interest at 9.25% and \$0.6 million bears fixed interest rates ranging from 6% to 17.5%. Since these debt instruments bear interest at fixed rates, we have no exposure to decreases in interest rates because we still are required to pay the fixed rate even if current interest rates are lower.

Foreign Currency Risk

We believe that our exposure to currency exchange fluctuation risk is reduced because our transactions with international vendors and customers are generally transacted in US dollars. The currency exchange impact on intercompany transactions was immaterial for the quarter ended September 30, 2003.

Item 4. Evaluation of Disclosure Controls and Procedures

(a) Evaluation of disclosure controls and procedures

Edgar Filing: MAI SYSTEMS CORP - Form 10-Q

Our chief executive officer and our chief financial officer, after evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-14(c) and 15-d-14(c)) as of a date (Evaluation Date) within 90 days before the filing date of this quarterly report, have concluded that as of the Evaluation Date, our disclosure controls and procedures were adequate and designed to ensure that material information relating to us and our consolidated subsidiaries would be made known to them by others within those entities.

(b) Changes in internal controls

There were no significant changes in our internal controls or to our knowledge, in other factors that could significantly affect our disclosure controls and procedures subsequent to the Evaluation Date.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

Internal Revenue Service

On September 30, 2003, the Company entered into a settlement agreement with the United States Internal Revenue Service (the Service) on a tax claim which resulted from the Company's Chapter 11 proceedings whereby it agreed to pay \$489,000 in equal monthly installments of \$7,438 over a period of six (6) years at an interest rate of 6%. The \$489,000 settlement is reflected as debt in the financial statements and resulted in a one-time gain of \$262,000 which is included in other operating income. In the event that the Company fails to pay the Service any payment, and such payment failure continues for sixty days after written notice of such failure, \$1,832,100, plus accrued interest thereon,

less any payments made by the Company will be immediately due and payable to the Service.

CSA Private Limited

CSA is a MAI shareholder. On August 9, 1996, MAI acquired from Hotel Information Systems, Inc. (HIS) substantially all their assets and certain of their liabilities (the HIS Acquisition). At the time of MAI s acquisition of HIS in 1996, CSA was a shareholder of HIS and, in connection with the purchase, MAI agreed to issue to CSA shares of its Common Stock worth approximately \$4.8 million in August 1996, which amount had increased to approximately \$6.8 million as of December 31, 2000, pursuant to the agreement. The Company entered into a settlement agreement with CSA in February, 2001 whereby it (i) issued CSA 1,916,014 additional shares of our Common Stock to bring CSA s total share ownership to 2,433,333 shares; (ii) filed a registration statement for all of CSA s shares of our Common Stock which has been declared effective by the SEC so that such shares are now freely tradable; and (iii) executed a secured debt instrument in favor of CSA in the principal sum of \$2,800,000 which is subordinate only to the Company s present group of two (2) senior secured leaders and required cash installment payments to commence in March 2002 (see note 6).

In connection with the settlement agreement with CSA, the Company recorded the \$2.8 million debt issuance as a reduction in paid in capital and the 1,916,014 additional shares at par as an addition to Common Stock and a reduction to additional paid in capital.

Cher-Ae Heights Indian Community

A lawsuit was filed by Cher-Ae Heights Indian Community (Cher-Ae Heights) against Logix Development Corporation (Logix), now known as MAI Development Corporation, as a co-defendant for a breach of contract by the Company s formerly owned gaming subsidiary along with the new owners, Monaco Informatiques Systemes (MIS), who acquired the assets and certain liabilities of the gaming subsidiary on July 27, 2001. Based upon this suit, MIS informed the Company that it did not intend to pay the next \$500,000 due to the Company under a promissory note and security agreement. On October 24, 2002, the Company entered into a global settlement agreement between the parties whereby all claims, known and unknown, between the parties were dismissed and the Company received \$796,000 (see note 5)

Logix Development Corporation

The Company entered into a settlement agreement with Logix in July of 2002 whereby it (i) issued Logix 200,000 shares of our Common Stock (ii) required the Company to make various cash installment payments totaling \$175,000 to be paid within 1 year and (iii) executed a contract with Logix for a consulting project in the amount of \$50,000.

Other Litigation

The Company is also involved in various other legal proceedings and claims that are incident to its business. Management believes that the ultimate outcome of these matters will not have a material adverse effect on the consolidated financial position, results of operations or liquidity

of the Company.

Item 2. Changes in Securities and Use of Proceeds

(a) None.

(b) None.

(c) None

(d) None.

Item 3. Defaults Upon Senior Securities

(a) None

Item 4. Submission of Matters to a Vote of Security Holders

(a) None

(b) None

(c) None

(d) None

Item 5. Other Information

(a) None.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1 Certification of Chief Executive Officer, W. Brian Kretzmer, as required by Section 3.02 of Sarbane-Oxley Act of 2002

31.2 Certification of Chief Financial Officer, James W. Dolan, as required by Section 3.02 of Sarbane-Oxley Act of 2002

32.1 Certification of Chief Executive Officer, W. Brian Kretzmer, as required by Section 9.06 of Sarbane-Oxley Act of 2002

32.2 Certification of Chief Financial Officer, James W. Dolan, as required by Section 9.06 of Sarbane-Oxley Act of 2002

(b) Reports on Form 8-K

Filed May 2, 2003

Filed April 30, 2003

Filed April 24, 2003

Filed November 5, 2003

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MAI SYSTEMS CORPORATION
(Registrant)

Date: November 6, 2003

By: /s/ James W. Dolan
James W. Dolan
Chief Financial and Operating Officer
(Chief Financial and Accounting Officer)